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***GOVERNOR OUTLINES BUDGET PLANS  
Work Underway to Manage Shortfall***

PHOENIX – Governor Janet Napolitano has released detailed plans for handling any projected shortfall in the current budget for FY 2009. Although some of the plan will require legislative action, much of the work is already underway.

Arizona’s fiscal year began in July. Because the national economy is in a significant downturn, state revenues are coming in well below the amounts originally projected. Although data is still limited, because it is early in the fiscal year, economists’ best predictions show a range for Arizona’s shortfall for the full fiscal year: at the low end, \$320 million; a mid-range estimate of \$450 million; and a pessimistic, high-end projection of \$800 million, should the economy stay slow for a protracted period of time. These forecasts are based on the best information available now. Economic conditions are updated on a monthly basis, and the forecasts will be adjusted accordingly.

The Governor has proposed a mix of proposals to handle the shortfall. The plans include further reductions in state agency costs; transfers of unused funds; use of the state’s ‘rainy day’ fund for its intended purpose; and additional state budget management options. The additional options could include things like fees charged to states that house the inmates in private prisons in Arizona; securitization of the tobacco settlement; or sale or lease of the Arizona lottery. Those options remain under study.

A chart is attached, depicting how funds would be used to achieve balance given the range of scenarios.

The Governor was clear in her priorities. “My goal is to protect classroom spending for K-12 education, and to ensure that we continue to provide service to vulnerable Arizonans, including children, veterans and seniors,” said the Governor. Napolitano added, “I am absolutely committed to achieving budget balance without increasing taxes.”

No matter what the ultimate scenario, balancing the budget will not be an easy task. As the second attached chart shows, 45 percent of Arizona’s budget is protected – because it involves a formula passed by voters, or is mandated under federal law – and cannot be cut. All cuts must come from the remaining 55 percent of the state budget.

Arizona agencies have been actively working, for more than a year, to find cost savings. For example, a hiring freeze ordered by the Governor in March, is projected to save an estimated \$40 to \$50 million dollars by the end of the current fiscal year.

Again, some of the measures will require legislative action. For that reason, the Governor has scheduled a meeting with Senate President Tim Bee and House Speaker Jim Weiers for November 6<sup>th</sup>. During the month of October, she will meet separately with each.

Yesterday, the Governor, Bee and Weiers agreed to direct their respective budget teams, JLBC (the Joint Legislative Budget Committee) and OSPB (the Governor's Office of Strategic Planning and Budgeting) to meet this week to come up with a consensus estimate of the shortfall for the current year to date.

Attached please find: a bar chart outlining various scenarios and plans; a pie chart demonstrating protected and unprotected parts of the Arizona budget; and a copy of the Governor's Budget Management Plan for FY 2009.

For more information about the Office of the Governor, please visit [www.azgovernor.gov](http://www.azgovernor.gov).

# State of Arizona

Janet Napolitano, Governor

## Budget Management Plan Scenarios

Fiscal Year 2009

October 1, 2008

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## **Section I: Background and Context for Managing the FY 2009 Budget**

Since the passage of the FY 2009 budget in June 2008, economic conditions have further deteriorated. The housing downturn continues, and consumer confidence is at historically lows.

### **National Outlook**

The U.S. economy finished the first half of CY 2008 better than expected, thanks to the stimulus package enacted by Congress and strong exports. However, the housing downturn is not over, as the government takeover of Fannie Mae and Freddie Mac made clear. The economy continued to weaken recently as Lehman Brothers declared bankruptcy, Bank of America bought Merrill Lynch, the federal government bailed out AIG, and other firms struggled to raise capital. Although it is still pending, government action to pump massive liquidity into the system is expected to help to unfreeze the credit market and allow the economy to recover.

- ❑ **GDP growth:** Global Insight forecasts U.S. GDP growth to follow a W-shaped profile, with the second and third quarters of CY 2008 the strongest due to the stimulus package. The forecast expects a sustainable recovery as housing prices bottom out in mid-2009, with GDP growth bouncing back to 2% in quarter 2 of 2009. Consumer spending in 2008 is expected to slip to 1% from 2.8% in 2007.
- ❑ **Employment growth:** Payroll employment has declined for eight months in a row, averaging 76,000 fewer jobs per month between January and August compared to the same period last year. The unemployment rate has risen to 6.1%. However, unemployment rates are better than those faced during the 1990-91 and the 2001 recessions.
- ❑ **Interest rates:** As inflation fears ease and credit conditions continue to tighten, Global Insight expects the Fed funds rate to hold at 2%. Due to weakness in the financial system, rate cuts are not out of the picture.

**Potential risks:** An even steeper housing downturn coupled with another spike in energy prices could drag the economy into a deeper downturn than previously forecasted. Potential risks to the economy include a bigger sub-prime decline, a continuing U.S. housing downturn, a weaker job market, a bigger consumer retrenchment, and more risk aversion by businesses, plus any geopolitical shock.

### **Arizona Outlook**

Arizona was heavily affected by the housing downturn. Although the economy is expected to be close to bottoming out, according to Global Insight, Arizona's growth is expected to stay weak through the end of 2008 as housing prices and construction continue to decline. Revenue collections have shown further weakness, as employment deteriorates and consumers continue to hold back, evidenced by July-August collections falling more than \$100 million below the enacted forecast.

- ❑ **Employment:** Arizona employment growth has been weak in the past few months. From January through August, Arizona employment decreased by 18,700 jobs from the same period last year, while the unemployment rate rose to 5.6% in August. The most recent forecast from the Arizona Department of Commerce suggests that Arizona will experience a slight job loss of (0.5)% in calendar year 2008 before returning to modest growth 0.1% in calendar year 2009.
- ❑ **Real estate:** The deepening housing decline has resulted in declining retail sales in the State, and coupled with recent Wall Street crises, Capital Gains income is likely to diminish. It is expected that Arizona residential real estate activity growth will decrease further in the last two quarters of calendar year 2008 and will start to stabilize in 2009.

**Potential risks:** A prolonged national downturn will adversely affect the State as in the past.

**Conclusion:** As a result of economic events and a revised outlook, it is prudent to take action to prepare Arizona for a challenging economic environment to continue into 2009.

## Section II: Overview of the Budget Management Plan

At the Governor's direction, the Governor's Office of Strategic Planning and Budgeting (OSPB) prepared three Budget Management Plan scenarios, covering a range of FY 2009 revenues. These plans have been developed to ensure the FY 2009 budget remains in balance.

The policies used to achieve this plan are as follows:

1. The integral functions of State government must not be compromised.
2. Recommended spending reductions will be on an agency-by-agency and program-by-program basis, not across-the-board.
3. All voter-protected and constitutionally created programs will be exempt from spending reductions.
4. Appropriate application of previously used and accepted budgetary practices will be employed.

The Budget Management Plan consists of four elements:

- A **State agency budget savings strategy**, which will reduce State General Fund expenditures by \$75 million to \$250 million in FY 2009.
- Use of the **Budget Stabilization Fund** (Rainy Day Fund), with approximately \$120 million available in FY 2009.
- **Fund Transfers** of approximately \$50 million from balances of other funds to the General Fund.
- **Additional FY 2009 Budget Management Options** are expected to generate between \$75 million and \$380 million toward balancing the General Fund.

Sections III, IV, and V of this Plan provide additional details regarding each of the elements of the Plan.

The following chart summarizes the key elements of the Plan (in millions of dollars):

|                                      | Optimistic | Baseline   | Pessimistic |
|--------------------------------------|------------|------------|-------------|
| State Agency Budget Savings          | 75         | 150        | 250         |
| Rainy Day Fund                       | 120        | 120        | 120         |
| Fund Transfers                       | 50         | 50         | 50          |
| Additional Budget Management Options | <u>75</u>  | <u>130</u> | <u>380</u>  |
| Total Budget Management Plan         | 320        | 450        | 800         |

The total revenue shortfall is subject to revenue updates and could decrease if proposed Federal assistance is approved.

Pursuant to an agreement between the Governor, Speaker of the House and President of the Senate, OSPB and JLBC shall meet between now and November 6, 2008 to arrive at a consensus revenue forecast.

If the shortfall for FY 2009 is more or less than projected, the State Agency Budget Savings and Additional Budget Management Options will be adjusted.

## **Triggered Adjustments**

The Budget Management Plan includes two types of triggers:

The first trigger deals with a situation that occurs if the fiscal deficit is greater than the anticipated baseline estimate of \$450 million. This trigger will adjust the Budget Management Plan to accommodate a shortfall of up to \$800 million.

Conversely, the second trigger will allow for the restoration of Budget Management Plan agency reductions once the deficit has fallen below the anticipated baseline estimate of \$450 million. This trigger will restore agencies' funding back to the amounts enacted in June 2008 for FY 2009 before any other actions are taken (such as Rainy Day Fund deposit, tax cuts, etc).

## Section III: Budget Savings Directive

### Summary

In July 2008, the Governor instructed state agency directors to reduce spending and control costs in FY 2009. At the Governor's direction, all agencies are reporting expenditures on a monthly basis and are providing expected expenditures for all funds.

The Governor and OSPB will continue to meet with agency directors to focus on budget reductions and their associated implications for statutory mandates and services provided.

Of the \$9.97 billion appropriated for FY 2009 expenditures by state agencies, the following amounts are protected from budget reductions:

|                                |               |
|--------------------------------|---------------|
| Voter protected                | \$1.38        |
| Constitutionally established   | 0.27          |
| Judicial/Legally protected     | 0.22          |
| Federal Entitlement or mandate | 2.18          |
| Federal match                  | <u>0.44</u>   |
| Total Protected Amount         | <u>\$4.49</u> |
| Unprotected Amount             | <u>\$5.48</u> |

Rather than across-the-board percentage cuts, specific budget reduction goals will be set for each agency.

October 2008

Dear Agency Director:

As you are well aware, revenue collections for FY 2009 remain below the budget forecast. It is not known at this time when the economic cycle will turn again to stimulate growth in revenues. We anticipate that up to \$300 million in savings, over-and-above expected revertments and not including fund transfers or shifts, need to be identified. Rather than waiting, Governor Napolitano directs that all state agencies take immediate action to reduce spending and control costs.

The Governor appreciates the manner and spirit in which state employees have already worked to achieve savings and cut costs.

While many of you may have already planned or initiated spending reductions, the Governor directs the following budget savings measures be continued:

- Set aside funds for possible budget reductions
- Expand vacancy savings beyond the enacted hiring freeze amount
- Restrict travel
- Use teleconferencing and telecommuting to reduce expenses
- Defer signing new services contracts; review existing contracts for possible savings
- Defer replacement of equipment
- Eliminate or reduce overtime expenses not critical to public health or safety
- Eliminate any expenses that are not mission critical and absolutely necessary
- Eliminate expenses for employee training that is not critical
- Increase productivity, e.g., number of inspections per day per staff member
- Reduce energy consumption and expenses, e.g., gasoline, electricity
- Increase collection of monies owed to the state
- Transfer expenses to non-general fund accounts wherever possible
- Obtain additional federal funds; leverage them to do more.

If you have recommendations for additional actions that might be helpful, please contact your OSPB analyst so your suggestions may be shared with all State agencies.

I believe our collective efforts and timely implementation of these budget spending reductions will help generate savings to enhance our ability to continue to deliver vital public services during this slow economic phase. Please let me know if you have any questions regarding these steps.

Sincerely,

James J. Apperson,  
Deputy Chief of Staff for Finance and Budget  
Director, Governor's Office of Strategic Planning & Budgeting

## **Section IV: Fund Transfers**

OSPB will identify available fund balances that can be used to support General Fund expenditures without reducing mandated services of state agencies.

Some of the funds that may have available balances are:

- Citizens Clean Elections Commission Fund
- Drinking Water Fund
- Emergency Telecom Revolving Fund
- Indirect Cost Fund
- Industrial Commission Administrative Fund
- Job Training Fund
- Local Transportation Assistance Fund II
- Motor Vehicle Liability Insurance Enforcement Fund
- Parks State lake Improvement Fund
- Risk Management Revolving Fund
- State Aviation Fund
- State Lottery Fund
- Tourism Fund
- Underground Storage Tank Revolving Fund
- Vehicle License Tax
- Water Banking Fund

The amount, if any, that is available for transfers from each of the more than 1,000 state funds is currently being evaluated. A preliminary list of amounts is expected to be available within two to three weeks, with a final list completed shortly thereafter.

## **Section V: Budget Stabilization Fund (Rainy Day Fund) Transfer**

### **Summary**

The Budget Stabilization Fund (BSF) for Arizona was enacted in 1990 (A.R.S. § 35-144). The BSF is designed to set revenue aside during times of above-trend economic growth and to utilize this revenue during times of below-trend growth. It is, in essence, the state's savings account. In prior years, the BSF has been tapped for uses not originally intended by the statute. For example, funds from the BSF were used to pay for the Arizona State Hospital in Fiscal Years 2000-2003. In Fiscal Years 2001-2007, BSF funds were transferred for payments on the Alternative Fuels Tax Credit. After these raids, the BSF was entirely replenished by FY 2008. The use of the BSF in the Governor's Budget Management Plan is exactly consistent with the intended use of the fund.

Funds from the BSF were used to help with the FY 2008 budget shortfall when the economy starting turning down. The current cash balance in the BSF is \$201,562,584.62<sup>1</sup>, and approximately \$80 million is estimated to be used to balance the FY 2008 budget per Laws 2008, Chapter 53, Section 26. The Governor's proposal is to transfer \$120 million to the General Fund to help balance the FY 2009 budget, utilizing the BSF for its intended purpose.

<sup>1</sup>Cash balance as of the end of August 2008 per the Arizona Financial Information System.

## Summary of FY 2009 Budget Management Plan Components

